Internal Revenue Service

memorandum

CC:TL
Br4:GJDickey

date: 23 MAY 1986

to: Seymour I. Sherman, Special Trial Attorney
Chicago, Illinois MW:CHI

from: Director, Tax Litigation Division CC:TL

subject: [redacted]

This is in response to your request for technical advice in the subject case.

ISSUE

In computing its I.R.C. § 56 corporate minimum tax for tax years [redacted] and [redacted], did the taxpayer, pursuant to the "tax benefit rule" of I.R.C. § 58(h), properly reduce the sum of its tax preferences by the amount of foreign tax credits which it could not use to reduce its regular tax for those years due to such preferences? 0056.00-00.

CONCLUSION

The existence of foreign tax credit should be ignored in applying the "tax benefit rule" of I.R.C. § 58(h). Therefore, the taxpayer is liable for minimum tax on its tax preference items for the years at issue even though foreign tax credits would have eliminated its income tax liability had the tax preference items not been available.

FACTS

The subject case involves the taxpayer's taxable and calendar years [redacted] and [redacted]. The taxpayer's memorandum of [redacted], which you enclosed with your request, states that deficiencies of $[redacted] and $[redacted] respectively were determined by the Service for those years. Although the factual analysis in the taxpayer's memorandum is detailed and informative, in sum it simply explains that during the years at issue the taxpayer had sufficient foreign tax credits to eliminate its regular income tax liability even without tax preferences and that it could not carry back any excess credit "freed up" due to its utilization of those preferences. The only other truly noteworthy fact is your observation that the taxpayer will apparently be able to utilize all or part of its credit as a carryforward to one or more subsequent tax years.

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DISCUSSION

As you are aware, under I.R.C. § 58(h), the Secretary is to prescribe regulations implementing the tax benefit rule in regard to tax preference items. Pursuant to this mandate, proposed regulations have, in fact, been prepared and have been approved by the Regulation Policy Committee. The notice of proposed rulemaking is presently awaiting approval by the Treasury Department and has yet to be published in the Federal Register. Although the proposed regulations remain without effect, they clearly may delineate Service policy in this area in the future. Accordingly, it is noteworthy that as presently drafted they would not allow taxpayers to take non-refundable credits and credit carryovers into account in determining the amount of tax benefit received from the tax preference items. One of the primary reasons for this is the statutory language of I.R.C. § 901 which states that the foreign tax credit should not be allowed "against any tax treated as a tax not imposed by this chapter under section 26(b)." I.R.C. § 26(b) in turn specifies that section 56 "shall not be treated as a tax imposed by this chapter."

Although counsel for [redacted] evidently did not consider this clear statutory restriction significant enough to address in its memorandum, we do not think that it can be disregarded so easily. It appears to us that the taxpayer's proposal would entail indirectly allowing that which the Service is explicitly prohibited by the statute from allowing directly. Offsetting the tax preferences used to compute I.R.C. § 56 tax by the amount of foreign tax credit which must be carried over, would obviously reduce the tax imposed under section 56. This is tantamount to allowing the foreign tax credit against the corporate minimum tax (albeit to a more limited extent than as a dollar for dollar credit). Thus, we contend that at the very least the taxpayer's proposal does not comport with the spirit of I.R.C. § 901.

The United States Court of Claims in Occidental Petroleum Corporation v. United States, 685 F.2d 1346 at n.9 (Ct. Cl. 1982) (hereinafter Occidental I), made three observations in regard to this issue which warrant repetition:

> (1) under the taxpayer's theory it would keep its preferences, leaving more foreign tax credit for possible use in future years although the preferences would have already conferred a benefit if the credits are eventually used, while the taxpayer would have been taxed for such years as if it had not taken the preferential deductions;

(2) the objective of I.R.C. § 901(a) appears to be that foreign tax credits are not to be used in any way to reduce minimum tax (either directly or otherwise).

(3) the reason the indirect reduction sought by the taxpayer was not specifically addressed by Congress in a separate code provision may well have been that I.R.C. § 901(a) automatically prevents such indirect action;

Clearly I.R.C. §§ 56 and 57 contain no language providing for the exceptions sought by the taxpayer. On the other hand, in addition to I.R.C. § 901(a), Congress directly adverted to the role of the foreign tax credit under I.R.C. § 56, which applies the minimum tax to items of tax preference exceeding the greater of $10,000, or the regular tax deduction for the taxable year reduced by credits, <u>specifically including the foreign tax credit</u>. <u>See</u> I.R.C. § 56(c). 1/ Accordingly, Congress was fully cognizant of the interaction between the foreign tax credit and the I.R.C. § 56 tax.

We also note that I.R.C. § 58(g) -- the very subsection preceeding the tax benefit provision relied upon by the taxpayer -- provides, in regard to foreign source tax preferences, that "items of tax preference shall be treated as reducing the tax imposed by this chapter before items which are not...." This underscores Congressional awareness, in regard to the I.R.C. § 56 tax, of foreign source income and the relationship between foreign tax credits and preference items in calculating the tax.

We are unconvinced that Congress intended to tacitly override these provisions through enactment of I.R.C. § 58(h) which merely directs the Secretary to prescribe regulations allowing proper adjustment to tax preference items "where the tax treatment <u>giving rise</u> to such items will not result in reduction of the taxpayer's tax ... for <u>any taxable years</u>." I.R.C. § 58(h). (Emphasis added). Clearly, the foreign tax

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1/ The United States Court of Claims elaborated on the significance of this by noting that "[t]he provision thus focuses on the amount of money actually paid to the United States Treasury after the foreign tax credit is taken into account, not the amount of tax calculated before reduction on account of foreign or other tax credits. That method of calculation strongly suggests that Congress intended to impose the minimum tax on those who, in spite of large incomes, had escaped contributing to the treasury because of the application of the foreign tax credit." 685 F.2d at 1348.

credit does not give rise to any item of tax preference. Even if it did, 2/ the tax benefit rule would only apply if the credit would not reduce the taxpayer's tax in any taxable year. This cannot be determined in regard foreign tax credits until they have expired unused. Until that time it is the unreduced preference items attributable to the tax year at issue which are the object of I.R.C. § 56 tax. After all, I.R.C. § 56(c) specifies the role which foreign tax credits play in determining corporate minimum tax and there is no separate prevision, such as that found under I.R.C. § 56(b) concerning net operating losses, which indicates they should, in any way, affect the amount of tax preference computed.

Although [redacted] correctly notes that there may be special difficulty concerning the statue of limitations where investment tax credits are involved, and potentially in some cases involving foreign tax credits, we note that this is not the case here. Because regulations are pending, we do not think it appropriate to speculate as to these possibilities at this time.

Finally, the taxpayer relies heavily upon the Tax Court's decision in Occidental Petroleum Corporation v. Commissioner, 82 T.C. 819 (May 24, 1984) (hereinafter Occidental II). While the decision admittedly does not wholly comport with our reading of the tax laws in this area, it is not patently unreasonable absent promulgation of Treasury Regulations. As noted in your request, however, the taxpayer here seeks to go beyond Occidental II in that it wants the Service to agree that if it is able to utilize released credits as carryforwards, it has a liability for the minimum tax in that subsequent year or years, rather than in the taxable years in which the preference items arose. The Tax Court's Occidental II decision emphasized that the preferences involved in that case did not result in a tax benefit directly or indirectly in respect of any possible applicable year. Moreover, the Court also strongly emphasized the absence of Treasury Regulations in this area.

2/ See The Tax Reform Act of 1976 Joint Committee Explanation, reprinted in 1976-3 Vol. 2 C.B. 118-119. Although the Joint Committee stated that "[t]here are certain cases in which a person derives no tax benefit from an item of tax preference because, for example, ... the taxpayer has sufficient deductions relating to nonpreference items to eliminate his taxable income," we note that the examples set forth by the Committee deal with preference items that give rise to deductions which must be suspended pursuant to I.R.C. §§ 465 and 704(d), and disallowed investment interest under I.R.C. § 163(a). Unlike credits, these deductions are directly related to specific preference items.

Accordingly, we believe that taking the course of action proposed by the taxpayer at this time, would be presumptive and premature. Promulgation of Treasury Regulations in this area is critical to an appropriate and detailed policy.

This respose has been informally coordinated with Mr. Robert B. Coplan, who has been the Legislation and Regulations Division expert in this area. If you have any further questions or need additional assistance in this matter, please contact Gordon John Dickey of this office at FTS 566-3345.

ROBERT P. RUWE
Director

By: HGS

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